

STABILIZATION POLICY: TIME FOR A REAPPRAISAL?

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The combination of rampant inflation and distressingly high unemployment over the last few years represents the worst conjuncture of economic events since the Great Depression of the 1930's. These events have brought severe distress to many individuals and organizations and shaken the foundations of some economic and financial institutions that were thought to be invulnerable. They have also shaken the confidence of the economics profession and caused many economists to question some of the basic premises of economic stabilization theory. One of the long-time practitioners of the "dismal science" recently summed up the feelings of many of his professional colleagues when he woefully commented that "The old rules no longer apply." Reflecting this attitude, some economists are calling for a re-examination of stabilization theory and for new approaches to economic stabilization policy.

This widespread confusion and self-doubt are of rather recent origin. Only a little more than a decade ago economists seemed supremely confident of their ability to control the level of economic activity and to achieve a nice balance among the objectives of economic growth, high-level employment, and price stability. With an extraordinary degree of confidence, practitioners of what became known as the "New Economics" spoke of their ability to "fine tune" the economy. The *Economic Report of the President* transmitted to the Congress in January 1965, for example, noted that in the effort to achieve balanced growth in the year ahead "Fiscal and monetary policies must be continuously adjusted to keep the aggregate demand for goods and services in line with the economy's growing capacity to produce them." One can picture a group of economists, seated before a huge console, feverishly twisting dials in order to achieve just the right mix of policies that will produce the optimum combination of economic results.

It should be noted at this point that while the questioning of basic premises is rather widespread, it is by no means unanimous. Indeed a number of economists would question the proposition that there has been any change in the economic fundamentals, and they would deny that there is anything approaching a crisis in stabilization policy. The old rules have not changed, they say, and all we have to do is return to the old-time religion. On the other hand, there are a few economists who contend that the entire body of contemporary economic theory is without substance and largely irrelevant. But there are a great many economists who have been sorely troubled by the events of recent years and who fear that important institutional changes over the last several decades have altered the way the economy responds to traditional stabilization actions. More importantly, perhaps, the unfortunate combination of strong inflation and high unemployment has caused an important segment of the American public to question the efficacy of our economic system and even our form of government.

The purpose of this article is to review, briefly and in a nontechnical fashion, the historical development of stabilization theories and to describe the recent developments that have caused some economists to begin to reevaluate these theories.

The Classical Period Prior to the Great Depression of the 1930's, the majority of economists were not much concerned with what we would call stabilization theory and policy. The so-called classical and neoclassical school of economic thought was dominant throughout the century and a half between the publication of Adam Smith's *Wealth of Nations* and the economic collapse of the early 1930's. There was a gradual growth and refinement of the basic body of economic thought over this period, and, of course, at

any given time significant differences might be found in the thinking of the individuals comprising the classical school. Thus, it is difficult to summarize in a few brief paragraphs the thinking of this large and important group of economists without doing injustice to individual members of the group. Nevertheless, most of the members of the classical school adhered to certain basic principles, and it may be possible to describe those aspects of the classical system that were relevant to the question of economic stabilization.

The classical and neoclassical economists believed the economy was inherently self-stabilizing. A basic feature of their system was the concept of long-run full-employment equilibrium toward which the economy tended to move. From time to time exogenous shocks would disturb the basic equilibrium of the system, but there were powerful forces, operating through the market system, to return it to a new equilibrium. Prices, wages, and interest rates were generally assumed to be highly flexible in response to changes in supply or demand, although some of these economists recognized the possibility of problems arising from sticky prices or wages.

In a system possessing these characteristics, unemployment of resources would be only a transitional phenomenon, at worst. Flexible interest rates would tend to equate savings and investment at the full-employment level, and flexible prices and wages would insure that markets for goods and labor would be cleared. Beyond temporary transitional periods, changes in aggregate demand for goods and services would not affect the level of output and employment; they only changed the general price level. An increase in aggregate demand at a pace faster than the growth in productive capacity would simply raise the levels of prices. A fall in aggregate demand would not cause unemployment; it would merely reduce prices and wages.

Even the most orthodox of the classical economists recognized the obvious fact that in the real world depressions and inflation did occur, and that from time to time aggregate demand might be inadequate to insure full employment. These rather frequent periods of depression were usually considered to be the result of temporary disturbances of markets caused by such things as speculative excesses, a general loss of confidence, an abnormal contraction of credit, or a sharp decline in the money stock. In the longer run,

the classicists believed, powerful forces were at work to restore full-employment equilibrium. The unemployment that accompanied depressions was considered to be one of two types: It might be frictional unemployment caused by people changing jobs, ignorance of job opportunities on the part of workers, or some other temporary imperfection in the labor market. Or it could be caused by collusion on the part of labor in a stubborn refusal to accept employment at a wage equal to their marginal productivity. Unemployment of the latter type was considered "voluntary." Some orthodox economists even described the massive unemployment of the 1930's in these terms.

It is clear from the foregoing that government stabilization policies played no role in the classical scheme of things. Indeed, the doctrine of *laissez-faire*, one that called for a minimum of government intervention in the economic affairs of the nation, was the dominant philosophy during this period. The classical writers would have considered government intervention not only a threat to individual freedom, but also a destabilizing force in the economy. The strength of the *laissez-faire* philosophy is indicated by the fact that Herbert Hoover was the first American President to attempt to use the powers of the central government to alleviate the harmful effects of a depression.

It would be a serious mistake to conclude, however, that the classical and neoclassical doctrine went unchallenged from the days of Adam Smith to the Great Depression of the 1930's. As a matter of fact, critics abounded from the earliest days of the period. Some of these, working within the great mainstream of classical thought, contributed to the growth and evolution of this school of thought. Others attacked the classical doctrine from without. In addition, Wicksell and some of the other great continental economists were pursuing quite different approaches to economic analysis, and in the United States Veblen, Commons, Mitchell, and the other institutionalists were questioning all economic theory.

As time went on, the orthodox economic theory seemed to conform less and less to economic reality, and efforts to construct an alternative increased. As Hansen notes, this activity became especially strong following the turn of the present century, particularly among the economists who began their professional lives in the period

around World War I.¹ Much of this work was related to the problem of economic fluctuations, and there were many attempts to refute the central tenet of neoclassical analysis, the premise that there is a basic tendency for the economy to move automatically toward full employment. But the problem faced by these economists was that "You can't beat something with nothing." Critics of the classical system had no generally acceptable body of theory to take its place. Even some of the more effective dissenters, such as J. M. Clark, continued to use the classical analysis.

The Keynesian Revolution An alternative theoretical approach was provided in 1936 with the publication of a book by the English economist, John Maynard Keynes. His *General Theory of Employment, Interest and Money* is a rather poorly written and sometimes confusing book, but with the exception of Marx's *Das Kapital* it was perhaps the most influential book on economics since Adam Smith.

Keynes attacked head-on the central tenet of the classical theory, i.e., the tendency of the economy to move constantly toward a condition of full-employment equilibrium. As expounded by a leading classicist of that day, A. C. Pigou, this tendency toward full employment rested on two conditions: (1) flexible interest rates would insure full use of resources by equating saving and investment, and (2) flexible wage rates would ensure full employment, regardless of the level of total demand.

Keynes contended that both of these principles were fallacious. Saving and investment are two entirely separate processes and are not mutually determined by any single variable, such as the interest rate. Saving, he said, is determined by the level of income; the level of investment depends on the relationship between the rate of interest and the return on investment. If planned investment fell short of the level of saving at full employment, realized saving and investment would be equalized through a fall in income (and saving). It is possible, therefore, for equilibrium to be attained at a level of income below full employment. Flexible wages, even if they existed, would not ensure full employment. A fall in money wages would reduce consumption outlays and thus reduce total demand for goods and ser-

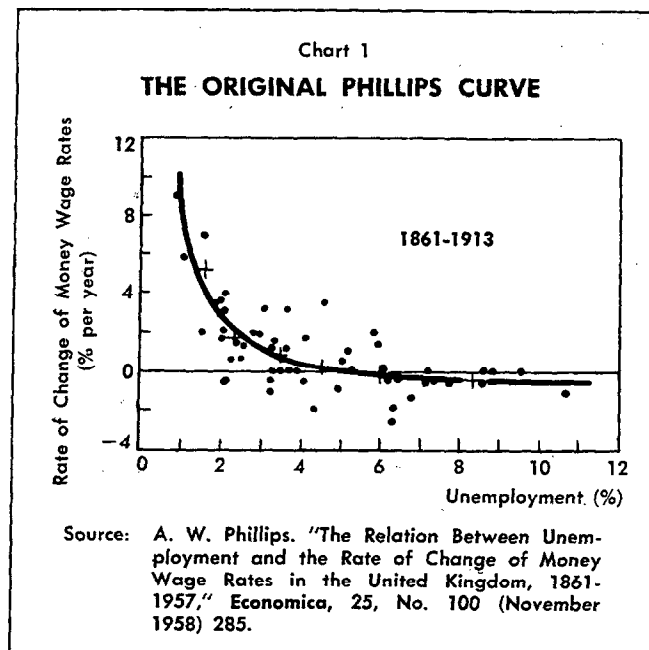
vices. The lower level of demand for goods and services would lower the derived demand for labor and therefore would not eliminate unemployment.

It is not our purpose here to discuss the details of the Keynesian system. This has been done many times over the last forty years, and in the process many features of the system have been changed and some that Keynes considered important have been ignored. But the importance of the *General Theory* is that it focused attention on the level of aggregate demand as the determinant of the level of output and employment. Moreover, it provided theoretical justification for the use of governmental actions to influence employment and prices by manipulating total demand. Fiscal policy was justified on the grounds that government spending is an important element of aggregate demand, while changes in taxes affect the private components of demand. Monetary policy could affect the investment component of demand by changing the level of interest rates.

If one accepts the idea that the economy does not move automatically toward full-employment equilibrium (indeed that equilibrium at less than full employment is quite possible) and that the government possesses the power to determine the level of employment and prices, then the exercise of that power becomes inevitable. And this is what happened in the years following the publication of the *General Theory*. Keynes's emphasis on the use of fiscal policy received an important boost when government spending during World War II wiped out the heavy unemployment that had persisted throughout the 1930's and the government commitment to stabilization policy was officially recognized in the Employment Act of 1946.

The Phillips Curve Many early Keynesians seemed to think of the "full-employment" level of aggregate demand as a relatively narrow range. At most points below full employment, a change in the level of aggregate demand would change employment with little or no effect on prices. At points above the full employment level, a change in aggregate demand would change prices with little or no effect on employment. As time passed, however, economists generally came to perceive the "stabilization band" as comprising a rather wide range, and this view received theoretical

¹ Alvin H. Hansen, *A Guide to Keynes* (New York: McGraw-Hill Book Company, Inc., 1953), pp. 4-11.



support with the publication of a paper in 1958 by the British economist A. W. Phillips.² Applying statistical analysis to wage and unemployment data for the years between 1861 and 1913, Phillips discovered an inverse relationship between these two variables. That is, there was a tendency for the rate of increase in wages to be high in periods when unemployment was low, and vice versa. These somewhat unsurprising findings became embodied in what was called the "Phillips curve."

Although expressing an unspectacular and rather commonsense idea, the Phillips curve was of considerable importance in the evolution of stabilization policy. Since the rate of change of prices is closely related to the rate of change of wages, the Phillips curve provided intellectual underpinning for the concept of a trade off between inflation and unemployment. The policymaker was given a choice over a wide range of combinations of unemployment and inflation. Because of the shape of the curve (see Chart 1), the higher the rate of unemployment, the lower would be the cost in terms of additional inflation of reducing the unemployment rate; conversely, the higher the rate of inflation, the less would be the cost in terms of additional unemployment of policies designed to restrain inflation. The role of the policymaker, therefore, was to choose the

"optimum" combination of unemployment and inflation given the Phillips curve confronting him. The actual choice, of course, would be a reflection of the values of the policymaker and, perhaps, important political considerations.

Something similar to the Phillips curve analysis has probably been the basis of economic stabilization policy since World War II, but it was not until the early 1960's that it received its most explicit statement as a guide to stabilization policy. In the *Economic Report of the President* transmitted to Congress in January 1962, a 4 percent unemployment rate was adopted as a "temporary" target. In a later discussion of this goal, a member of the President's Council of Economic Advisers in 1961 stated, "Four percent was chosen with an eye on the Phillips curve, specifically the 4 percent inflation that accompanied 4 percent unemployment in the mid-1950's."³

Recent Developments The concept of some sort of trade off between inflation and unemployment continues to play an important role in economic stabilization policy, but in recent years this idea has come increasingly into question. First of all, Phillips' work has been subjected to searching criticism with respect to theoretical and methodological considerations.⁴ But more importantly from the viewpoint of practical policy, it has become more and more difficult to reconcile the recent behavior of prices and unemployment with the idea of a smooth trade off between the two. As one economist notes "... there is as yet no convincing way of fitting the phenomenon of stagflation into the framework of post-Keynesian economics."⁵

A number of explanations have been advanced as to why the postulated trade off between inflation and unemployment may no longer be valid. One school of thought explains this in terms of the formation of expectations. According to this theory, expectations of future price behavior are formed on the basis of past price experience. If, following a period of price stability, the economy expands rapidly, wages may

² A. W. Phillips, "The Relation Between Unemployment and the Rate of Change of Money Wage Rates in the United Kingdom, 1861-1957," *Economica*, Vol. 25, No. 100 (November 1958), 285.

³ James Tobin, *The New Economics One Decade Later* (Princeton: Princeton University Press, 1972), pp. 16-17.

⁴ See, for example, M. Desai, "The Phillips Curve: A Revisionist Interpretation," *Economica*, Vol. 42, No. 165 (February 1975), 1-19.

⁵ Hendrik S. Houthakker, "Incomes Policies as a Supplementary Tool," in *Answers to Inflation and Recession: Economic Policies for a Modern Society*, ed. by Albert T. Sommers (New York: The Conference Board, 1975), p. 73.

be bid up and unemployment fall below some "natural" rate. Prices will begin to rise, and the price expectations of workers and businessmen will be disappointed. As the inflation continues, people's expectations will be revised; and this results in an upward shift in the Phillips curve, so that each rate of unemployment is now associated with a higher rate of inflation. For any given rate of inflation, unemployment will gradually rise back to the natural level, and the temporary stimulative effect of inflation will vanish. In the long run, unemployment will return to its equilibrium level, and the inflation rate will stabilize. An attempt to halt the inflation by reducing aggregate demand will initially cause a rise in unemployment. But persistent expectations of inflation may cause the Phillips curve to continue to shift to the right, and the response of inflation to a reduction in aggregate demand may be excruciatingly slow.

Another approach explains the recent "stagflation" in terms of institutional characteristics of product and labor markets. Okun, for example, distinguishes between what he calls "customer" product markets and "career" labor markets, on the one hand, and the "auction" markets postulated in traditional economic analysis on the other.⁶ In customer product markets, prices do not equate supply and demand. For most products, the price is set by the seller and the quantity sold is determined by demand conditions in the market, but the price is not established in the expectation of clearing the market. Because shopping is costly and bothersome, a continuing relationship is usually established between the customer and the supplier. In a similar fashion, long-term employer-employee relationships are established in labor markets. A firm's wage rates (and number of employees) may be influenced very little by short-run changes in demand, and Okun emphasizes the concept of "fairness" in the determination of long-run wage levels. Fairness in this case is defined in terms of the relationship of the firm's wage structure to other wages, or to the price of the firm's product, or to the workers' cost of living. According to this approach, the appearance of excess demand will first be reflected in a rise in prices in the "auction" markets and will then spread to customer product markets

and career labor markets only with a lag. Because of the stickiness of many wages and prices, inflation is slow getting started but it tends to gather momentum as it progresses, and wages and prices may continue to increase, with an adverse impact on employment, long after excess demand is removed.

These two explanations of the recent instability of the Phillips curve are not mutually exclusive, of course, and there is little doubt that both help to explain the recent failure of prices and unemployment to conform to the expected Phillips curve configuration. One of the weaknesses of the expectations approach, perhaps, is that it puts too little emphasis on the institutional aspects of the problem. The fact is, most prices and wages in our economy are not determined in the manner described in many economics textbooks. Producers of a great many products do not think of themselves as facing some market-determined price, and indeed they are not. They set their own prices, and the most important determinant of any price is the producer's estimate of current unit costs and anticipated future changes in costs. Wages of a great many workers are the result of a collective bargaining process where the most important factors are the relative bargaining powers of the participants. As Okun notes, however, wages in other firms and industries, the firm's profit picture, and changes in the workers' costs of living are important considerations. Moreover, prices of most products are not changed very often, while wage contracts often cover a period of several years.

Implications for Policy All of this has important implications for the conduct of stabilization policy, but just as there is no general agreement on the basic cause of the problem, there also is no agreement on the proper direction of policy in the kind of situation that prevails today. Those who attribute all of the instability of the Phillips curve to expectations of inflation believe that all that is needed to achieve price stability is to eliminate inflationary expectations and gradually to move unemployment back to the "natural" rate. For many of the economists emphasizing expectations, inflation is always and only a monetary phenomenon, and the most important factor in the control of inflation is the proper use of monetary policy to prevent it from getting

⁶ Arthur M. Okun, "Inflation: Its Mechanics and Welfare Costs," *Brookings Papers on Economic Activity*, No. 2 (1975), pp. 351-90.

started. Once it is started, however, and inflationary expectations are firmly embedded in the minds of businessmen and consumers, the only way to deal with it is to hold aggregate demand below the full-employment level until these expectations are eliminated. And because of the manner in which expectations are formed, this can be done only over an extended period of time. In a period like the present, those who stress the expectations factor would caution against an attempt to achieve a rapid recovery because of fears of creating new inflationary expectations.

Many economists acknowledge the importance of expectations in prolonging and strengthening the inflationary process, but they argue that institutional factors also play a role. They believe that fundamental changes in our society, our economy, and in the role of government have seriously weakened the traditional stabilization techniques insofar as the control of inflation is concerned.⁷ Some of these changes have helped to create an inflationary bias in our economy, while others have reduced the effectiveness of monetary and fiscal policy in controlling inflation. Foremost among these changes would be the decline in price competition in both product and labor markets. This, of course, has weakened the link between monetary and fiscal actions, on the one hand, and prices and wages, on the other. In addition, welfare programs and income maintenance policies of government and private industry have reduced the incentive for workers to search diligently for employment or to accept employment at a reduced wage. At the same time, minimum wage laws contribute to the inexorable rise in wage rates and, some believe, they may price many unskilled workers out of the labor market, thereby aggravating the unemployment problem. Regulatory policies of governmental agencies sometimes make price competition in the regulated industry impossible and contribute significantly to the downward inflexibility of prices.

Finally, our economy has become increasingly subject to influences originating outside our own borders. The elimination of barriers to international trade and financial flows over the last two decades has served to tie our economy

much more closely to economies abroad, with the result that economic developments in foreign lands may have an important impact on conditions in our economy. Some believe, for example, that the worldwide economic boom of the early 1970's, coupled with crop failures abroad, the temporary disappearance of the anchovies off the coast of Peru, and the sharp devaluation of the U. S. dollar, contributed greatly to the inflation experienced in the United States. These developments were followed by the sharp boost in energy prices imposed by the OPEC cartel, an illustration of our growing dependence on foreign sources of fuel and raw materials.

Some, but by no means all, of those economists who emphasize institutional factors and market imperfections advocate some kind of incomes policy. These proposals range from guideposts and jawboning, to control of certain basic materials prices, to full-scale wage, price, and profit controls. Some advocate temporary use of these powers during periods of inflation on the ground that their use would speed the adjustment of price expectations. Others advocate a permanent system of controls on the ground that it is needed to offset the market power of large corporations and labor unions. A great many economists question the efficacy of permanent, full-scale wage and price controls. Such controls, they argue, would seriously distort the functioning of the economy and lead to the inefficient allocation of resources. Some are skeptical of temporary controls on the ground that they are ineffective.

Economists of all persuasions favor some type of "structural" reform that would eliminate many of the institutional features that contribute to the inflationary bias in the economy or tend to reduce the response of wages and prices to traditional stabilization policies. But not surprisingly, there is little agreement on the specific list of items to be included in these reforms. A great many of the proposed reforms affect powerful vested interests, and the political obstacles to any significant action in this area are formidable.

Conclusion Recent experience clearly indicates the need for a serious reappraisal of our approach to economic stabilization policy. Such a reappraisal should recognize first that the problems we have had do not call for a scrapping of traditional stabilization tools. Indeed, some would

⁷ See, for example, an address by Arthur F. Burns, "The Real Issues of Inflation and Unemployment," delivered at the University of Georgia, September 19, 1975.

say that most of our recent problems resulted from ineptitude in the use of these traditional tools. But demand management is still necessary because inadequate demand can cause unemployment and excess demand can create or exacerbate inflation. At the same time, the limitations of these tools should be recognized. They are primarily effective in dealing with economic instability arising from an excess or deficiency of aggregate demand. They are not very effective in dealing with price increases arising from crop failure, the actions of an oil cartel, or against the cost-push price pressures so prevalent in our economy today. If used to combat this type of inflation they can be very costly, not only in terms of unemployment and lost output, but also in terms of a weakening of the social and political fabric of our society.

Efforts to control inflation and achieve an acceptable level of employment have not been very successful in recent years. This has been partly because of the extraordinary nature of some of the disturbances that have rocked the economy and partly because of the stubborn persistence of

inflationary expectations. In the absence of other approaches to economic stabilization, perhaps too much has been expected of the traditional techniques. This seems to have been particularly true of monetary policy. Some of the more ardent champions of monetary policy have claimed more for that policy than it can deliver, with the result that the central bank has been subjected to a great deal of criticism. Such exaggerated claims may seriously impair the ability of the Federal Reserve System to perform its traditional functions.

It may be that the recent problems of economic stabilization are a passing phenomenon, but if they are not, new policy approaches may have to be developed. The most obvious first step would appear to be the elimination of artificial barriers to competition in labor and product markets and the alteration of structural features that reduce the flexibility of the economy. But in order to achieve a reasonable degree of economic stability in the years ahead it may be necessary to develop new policy tools to supplement those presently in use.